APPENDIX A

Opinion of the Court of Appeals

(Filed January 20, 1964)

By STALEY, *Circuit Judge*. [GANEY, *Circuit Judge*, and NEALON, *District Judge*, concurring.]

The narrow but provocative question posed by this case is whether the Investment Company Act of 1940, 15 U.S.C. § 80a, applies to the Investment Fund resulting from the sale of variable annuity contracts to members of the public by The Prudential Insurance Company of America. The Securities and Exchange Commission answered this question in the affirmative, rejecting the view of Prudential that the Act exempts such a program because the contracts are offered and sold by an insurance company. The case is before us on the petition of Prudential for review of the order of the Commission entered pursuant to that determination.

Though there are variations in the form of the variable annuities which Prudential proposes to sell,[1] their salient characteristics are not disputed and their nature has been concisely summarized by the Commission in its opinion in this case:

> "In substance, the variable annuity contracts which Prudential proposes to sell to individuals provide that the purchaser will make monthly purchase payments of fixed amounts over a period of years (the 'pay-in' period), the proceeds of which, after certain deductions, will be invested in a portfolio of securities. The purchaser will be credited monthly with 'units' represent-

[1] Prudential also intends to offer variable group plans in addition to the individual contracts. However, because the Commission is presently dealing with the problems posed by such plans in its administrative capacity, they were excluded from the scope of its opinion. Accordingly, we do likewise.

ing his proportionate interest in this fund.' The value of these units will fluctuate, essentially depending upon the investment results of the fund. During the annuity, or 'pay-out' period, Prudential guarantees that the purchaser will receive in cash the varying value of a fixed number of units as monthly annuity payments.

"Specifically the payments made by the purchasers will be placed in a 'Variable Contract Account' which will be managed by Prudential and be subdivided into two accounts. The first, the 'Investment Fund' account, will have its assets invested primarily in common stocks and will constitute the fund in which the purchasers hold units; this account will be dedicated solely to the variable annuity contract holders and its assets will not be subject to claims of any other contract or policyholder of the company. The second, the 'Other Assets' account, an administration account, will receive the amounts deducted from the purchase payments to cover administration expenses, sales commissions, and certain taxes, and to provide a surplus or reserve for the obligations to purchasers contained in the contracts. Transfers will be made periodically from the Other Assets account to the Investment Fund account to meet the contractual requirements that the assets of the latter be equal to the company's existing obligations under the variable contracts. Any excess over the amounts estimated to be needed for the foregoing purposes may be declared as so called 'dividends' which will provide additional fund units or cash payments for the contract holders; it will also be available to support the guarantees on contracts administered by Prudential's other operations. Any deficiency resulting from lower mortality than assumed, for example, will be met out of the general surplus of Prudential.

"During the pay-in period a purchaser will have the right to terminate the contract and receive the value of all units credited to his account, less certain termination charges. If a purchaser should die during the pay-in period, the contract is automatically terminated and his beneficiary is paid the greater of (i) the value of all units credited to the purchaser's account or (ii) an amount equal to the total of all purchase payments made.

"Absent death or redemption, the pay-in period normally runs for at least 15 years. Thereafter, during the pay-out period, the variable annuitant is entitled to receive each month the current value of a fixed number of units determined at the end of the pay-in period. This number of units is calculated on the basis of the number of units accumulated by the purchaser during the pay-in period, an assumed annual investment increment of 2½% from dividend and interest income, and actuarial computations which take into account the length of the pay-out period anticipated in light of the age and sex of the purchaser and any co-annuitant. The value of the variable unit during the pay-in and pay-out periods will be determined at the end of each month and will reflect the changes in the market value of the securities in the Investment Fund account; realized gains and losses, and dividend or interest income. Deductions will be made for investment advisory and other expenses in an amount equal to 0.6% per annum of the value of the fund's assets and for taxes."

Prudential concedes that such contracts have been held to be "securities" within the meaning of the Securities Act of 1933, Securities and Exchange Commission v. Variable Annuity Life Insurance Co. [hereinafter called "VALIC"], 359 U.S. 65 (1959), and it is willing to register them under

that Act. Prudential argues, however, that the Investment Company Act of 1940 specifically excludes insurance companies from its scope.[2] The Commission acknowledged that Prudential is excluded from the Act, but held that the fund created by the sale of the contracts, which is to be used for investment purposes, gives rise to a separate investment company within the coverage of the statute. The Commission concluded that Prudential is not itself an investment company but is the creator of one, and proposes to be its investment adviser and principal underwriter.[3]

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[2] Insurance companies are excluded from the definition of "investment company" by 15 U.S.C. § 80a-3(c)(3). An insurance company is earlier defined as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State * * *." 15 U.S.C. § 80a-2(a)(17).

[3] The essence of the Commission's reasoning in this regard is contained in the following excerpt from its opinion:

> "Thus, Prudential is not itself an investment company, but it is the creator of one—and proposes to be its 'investment adviser' and 'principal underwriter.' That an exempt insurance company performs these functions is irrelevant. The Act's exclusion of insurance companies is to be readily explained; otherwise they would fall within the statute by reason of the investment activities which are a necessary ingredient of their insurance business. Where, however, an insurance company (or any other entity) creates a fund exclusively for investment, and sells equity interests in the fortunes of that fund, the exemption does not carry over to the fund. Furthermore, that Prudential may in the same contract also make, in its own name and backed by its own assets, certain insurance or annuity promises is also irrelevant. VALIC held that such promises do not make the contract as a whole exempt as 'insurance' though made by the same entity and backed by the same assets."

In this court, Prudential, premising its argument on the insurance company exclusion, asserts that this construction of the statute is inordinately complicated, abstruse, and without basis in law. It asserts that the statute is plain and forecloses Commission jurisdiction in this case. However, since it is conceded that Prudential is excluded from the Act, the issue is narrowed to the question of whether the Commission made a permissible interpretation in concluding that the variable annuity program results in the creation of a separate, non-exempt investment company.

Of course, in resolving this issue we start with the premise that securities legislation must be broadly construed in order to insure the investing public a full measure of protection. Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., U.S. (Dec. 9, 1963); Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953); Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946). The parties agree that the statutory definitions contained in the Investment Company Act of 1940 are cast in broad terms. The critical term is "company", which, so far as relevant to our discussion, is defined as "a trust, a fund, or any organized group of persons whether incorporated or not." 15 U.S.C. § 80a-2(a)(8).

The Commission determined that the variable annuity contracts constitute the purchasers an "organized group of persons"; that they create a "trust" held by Prudential for these purchasers; and, more importantly, that the separate Investment Fund resulting from the sale of the variable annuity contracts is a "fund" within the statutory definition. Based upon this last decisive holding, the Commission then concluded that the Investment Fund is the

"issuer" of the variable annuity securities, and that it is an "investment company" subject to the Act.[4]

On this score Prudential argues that the Act regulates only identifiable business entities with some sort of internal organization, and that it is the only such entity involved in this program. Thus, it is asserted that the purchasers cannot be described as an "organized group of persons;" that the plan has no elements of a common-law trust; and that the "fund" referred to in the Act means a mutual fund or any other similar entity, but not Prudential's Investment Fund. But, as Mr. Justice Brennan has cogently observed, the regulatory provisions of the Act "are of particular relevance to situations where the investor is committing his funds to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortunes will depend on the success of the investment." VALIC, 359 U.S. at 79 (concurring opinion). Furthermore, a study of the legislative history of the Act shows that Congress intentionally drafted the statutory definitions in general terms in order to control such situations regardless of the legal form or structure of the investment enterprise.

Initially, it must be noted that the Committee reports of both the House and the Senate state that the legislation was drafted principally on the basis of reports submitted by the Securities and Exchange Commission following an extensive study of investment trusts and investment companies undertaken at the direction of Congress. H.R. Rep. No. 2639, 76th Cong., 3rd Sess. 5-6 (1940); S. Rep. No.

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[4] "Issuer" is defined as "every person [natural person or a company] who issues or proposes to issue any security, or has outstanding any security which it has issued." 15 U.S.C. § 80a-2(a)(21).

"Investment company" means, inter alia, any issuer which "proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a)(1).

1775, 76th Cong., 3rd Sess. 1, 5 (1940). The Act itself contains a similar acknowledgment. 15 U.S.C. § 80a-1. The significance of such reports in ascertaining the intent of Congress in enacting securities legislation was recently underscored by the Supreme Court in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., U.S. (1963).

Among the various types of investment companies referred to in the exhaustive report of the Commission were those involving "an agency relationship between the individual contributors to the fund and the management upon whom they confer substantially a power of attorney to act as agent in the investment of the moneys contributed. *The group of individual investors is not a legal entity* but rather constitutes in essence a combination of distinct individual inferests. (Emphasis supplied.) H.R. Doc. No. 707, 75th Cong., 3rd Sess. 24 (1939). Additionally, the report made specific reference to an investment company known as the "Alexander Fund" which it described as "merely a descriptive name given to the commingled funds of numerous investors who employed W. Wallace Alexander as their agent to invest such funds." Id. at 46. Similarly, in describing the nature of the investment enterprises which Congress was seeking to control, the House Report quotes from the testimony of Commissioner Healy who stated that "Essentially these organizations are large liquid pools of the public's savings entrusted to managements to be invested." H.R. Rep. No. 2639, 76th Cong., 3rd Sess. 6 (1940).

In these circumstances we reject Prudential's argument that the broad statutory phrase "a trust, a fund, or any organized group of persons whether incorporated or not" refers only to recognizable business entities. On the contrary, the legislative history compels the conclusion that Prudential's Investment Fund is a "fund", as that term is used in the statute. As we have previously seen,

the Investment Fund is a completely segregated account, devoted to investing in securities. The cash for these investments is derived from payments made by the purchaser of the variable annuity contract. Though the proceeds of the fund are held for the sole benefit of the annuitant, it is this fund, and no other entity, in which he has an interest.[5] Thus, the fund is separable from the insurance company which, as the Supreme Court noted in VALIC, "guarantee[s] nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor." 359 U.S. at 72. The restricted interest of the annuitant is perhaps best expressed in the Court's pithy observation that he "gets only a *pro rata* share of what the portfolio of equity interests reflects—which may be a lot, a little, or nothing." 359 U.S. at 71.

It follows from this that the Investment Fund, and not Prudential, is the "issuer" of these securities for the purposes of the Investment Company Act of 1940. As the Commission observed, "Prudential would in fact be the writer of the *contracts*—the insurance and annuity promises and the obligation to set up the investment fund. But the investment fund, the 'company' to which the investment interests relate, is the 'issuer' of those interests."[6]

One of the principal arguments of Prudential in favor of exclusion is that the existence of adequate state

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[5] It is true that any deficiency in the variable contract account resulting from lower mortality than assumed would be met out of the general surplus of Prudential. However, the actuary for Prudential testified that the deductions provided for in the contract would be more adequate to satisfy the annuity obligations. Hence, the annuitant's interest in the general assets of Prudential is, at best, *de minimis*.

[6] The mere fact that Prudential is the obligor of certain of the insurance and annuity features of the contract is not significant, for the annuitant's investment participation is measured solely by the Investment Fund.

regulation was the basis for the exemption of insurance companies. But this line of argument was conclusively rejected by the Supreme Court in VALIC for the reason that variable annuities are "securities" and involve considerations of investment not present in the conventional contract of insurance. Prudential attempts to distinguish VALIC on the grounds that the company there involved was not, on the basis of the Court's decision, primarily or predominantly engaged in the business of writing insurance. But regardless of the merits of this distinction, that case holds unequivocally that adequate state regulation of insurance is immaterial when variable annuity contracts are being considered under a Federal statute.

Prudential also asserts that the specific exemption provided for the common trust funds of banks shows that regulation under the Act was imposed on an institutional rather than on a functional basis. It is pointed out that this exemption is provided in addition to the general exemption for banks. Prudential declares that such common trust funds are functionally indistinguishable from investment companies, but were excluded from the Act "because they were in fact part of the banking business and intended to be covered by the broad exemption for banks." We think that this specific exemption leads to the opposite conclusion, for as the Commission reasoned:

> "* * * Obviously, if as Prudential argues, the exemption of banks and insurance companies had been intended to include an exemption of funds set up by such companies, there would have been no need to provide for the additional specific exemption of funds set up by banks. Congress thus viewed such funds, even though usually maintained as departments of the bank, as separate from the banking business. It rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes rather than as a medium for general public investment

and had only a limited impact in the investment fund picture."

Considerations of logic and policy provide further support for our conclusion. The Investment Company Act of 1940 contains significant safeguards for the protection of those who, like the purchasers of variable annuities, invest in "securities." These safeguards, characterized by the Commission as insuring "corporate democracy," include disclosure of investment policy and operating practices, and the regulation of fees, trading practices, and changes in investment policy. See VALIC, 359 U.S. at 79. The mere fact that the investment program in the case at bar is under the aegis of an insurance company ought not to negate compliance with these controls in the absence of compelling circumstances. We find no such circumstances here.

We have considered the other contentions advanced by Prudential, but find that they are merely variations on its insurance company exclusion argument and have been fully disposed of by the Commission.

The order of the Commission will be affirmed.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

APPENDIX B

The Findings and Opinion and Order of the Commission Dated January 22, 1963

By CARY, Chairman:

I.

We are here confronted again with the question of the impact of the Investment Company Act of 1940 ("Act") upon arrangements arising out of the issuance of variable annuity contracts.[1] The context is a request by the Prudential Insurance Company of America ("Prudential") for an order declaring that the offer and sale of variable annuity contracts will not subject Prudential, in whole or in part, to the Act.[2] In a so-called alternative application, Prudential asks that any entity found subject to the Act be exempted from certain of its provisions.[3]

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[1] *See The Variable Annuity Life Insurance Company of America*, Investment Company Act Release No. 2974 (February 26, 1960).

[2] The order is requested pursuant to Sections 3(b)(2), 3(c)(3) and 38(a) of the Act. Section 3(b)(2) essentially provides that an investment company shall not include any issuer which the Commission finds to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities. Section 3(c)(3) excepts an insurance company from the coverage of the Act. Section 38(a) empowers the Commission to issue rules, regulations and orders necessary or appropriate to the exercise of its powers.

[3] Prudential was organized in 1875 under the laws of New Jersey and is subject to regulation by the New Jersey Department of Banking and Insurance. Since its organization, it has been engaged in writing life and disability insurance. As of December 31, 1960, it had life insurance in force of about $82 billion and assets of over $16 billion. Prudential is a mutual insurance company with approximately 36 million policyholders. As Prudential describes it, "A mutual company has no owners except its policyholders, who have the sole power to vote for directors and who participate in the successful operation of the enterprise. [It] . . . is a non-profit financial institution whose function is to provide insurance protection to its contract holders at a price which is, as exactly as the sciences of accountancy and actuarial computation can determine, the cost of such protection to the company."

In substance, the variable annuity contracts which Prudential proposes to sell to individuals provide that the purchaser will make monthly purchase payments of fixed amounts over a period of years (the "pay-in" period), the proceeds of which, after certain deductions, will be invested in a portfolio of securities. The purchaser will be credited monthly with "units" representing his proportionate interest in this fund. The value of these units will fluctuate, essentially depending upon the investment results of the fund. During the annuity, or "pay-out" period, Prudential guarantees that the purchaser will receive in cash the varying value of a fixed number of units as monthly annuity payments.

Specifically the payments made by the purchasers will be placed in a "Variable Contract Account" which will be managed by Prudential and be sub-divided into two accounts. The first, the "Investment Fund" account, will have its assets invested primarily in common stocks and will constitute the fund in which the purchasers hold units; this account will be dedicated solely to the variable annuity contract holders and its assets will not be subject to claim of any other contract or policyholder of the company. The second, the "Other Assets" account, an administration account, will receive the amounts deducted from the purchase payments to cover administration expenses, sales commissions, and certain taxes, and to provide a surplus or reserve for the obligations to purchasers contained in the contracts.[4] Transfers will be made periodically from the Other Assets account to the Investment Fund account to meet the contractual requirements that the assets of the

[4] The deductions from the purchase payments will range from 41.7% to 54.2% of the first year's payments depending on the size of the payments, and will be smaller in subsequent years, averaging over a 15-year period from 10.2% to 14.8%. The variations in the ranges are based in part on the size of the contract purchase payments.

latter be equal to the company's existing obligations under the variable contracts. Any excess over the amounts estimated to be needed for the foregoing purposes may be declared as so-called "dividends" which will provide additional fund units or cash payments for the contract holders;[5] it will also be available to support the guarantees on contracts administered by Prudential's other operations. Any deficiency resulting from lower mortality than assumed, for example, will be met out of the general surplus of Prudential.[6]

During the pay-in period a purchaser will have the right to terminate the contract and receive the value of all units credited to his account, less certain termination charges. If a purchaser should die during the pay-in period, the contract is automatically terminated and his beneficiary is paid the greater of (i) the value of all units credited to the purchaser's account or (ii) an amount equal to the total of all purchase payments made.

Absent death or redemption, the pay-in period normally runs for at least 15 years. Thereafter, during the pay-out period, the variable annuitant is entitled to receive each month the current value of a fixed number of units determined at the end of the pay-in period.[7] This number of units is calculated on the basis of the number of units accumulated by the purchaser during the pay-in period, an

[5] As a mutual company, Prudential ordinarily would pass on to its policyholders the benefits of favorable mortality or expense experience; this could be done in the form of reduced premiums.

[6] The actuary for Prudential testified that the deductions provided for in the Variable Annuity Contracts would be more than adequate, in his opinion, to satisfy the variable annuity obligations of the company.

[7] The purchaser may elect one of three pay-out periods: (1) the purchaser's life, (2) a minimum ten-year period plus the purchaser's remaining life, or (3) until the death of both the purchaser and another designated person.

assumed annual investment increment of 2½% from dividend and interest income, and actuarial computations which take into account the length of the pay-out period anticipated in light of the age and sex of the purchaser and any co-annuitant. The value of the variable unit during the pay-in and pay-out periods will be determined at the end of each month and will reflect the changes in the market value of the securities in the Investment Fund account, realized gains and losses, and dividend or interest income.[8] Deductions will be made for investment advisory and other expenses in an amount equal to 0.6% per annum of the value of the fund's assets and for taxes.

In addition to the contracts described above which are to be sold to individuals, Prudential proposes to offer and sell variable group contracts as a means of funding employee pension or profit-sharing plans that are qualified under Section 401 of the Internal Revenue Code and to organizations enumerated in Section 501(c)(3) of the Code.[9] As we are presently dealing with the problems of group plans in an administrative capacity, we shall not treat them in this opinion.

II.

The variable annuity is a recent creation having several facets. It raises important, new and unresolved questions

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[8] Since the number of units to be distributed during the pay-out period is calculated on the basis of a 2½% investment increment assumption, a 2½% investment return is used as the base from which the actual investment results of the fund are measured. That is, the value of the units will increase only if the fund's investment results are greater than 2½%. The use of this factor involves increasing the number of variable units credited during the pay-in period at an effective rate of 2½% per year.

[9] See Rule 3c-3, Investment Company Act Release No. 3605 (January 7, 1963), which exempts transactions of insurance companies from the Act with respect to certain group annuity contracts where, among other things, benefits payable to employees are fixed.

as to the scope and interrelation of state regulation of insurance companies and the federal regulation of investment companies. These questions are of practical importance to the insurance and the investment industries and evoke strong and conflicting opinions. They are presented in a complicated form, since they involve the consideration together of the different operating and regulatory languages and techniques of "insurance" and "investment" which have in the past appeared only in separate contexts.

For the sake of clarity these competing considerations require that we emphasize certain points at the outset to avoid confusion and to eliminate possible misconceptions as to the issues and our holding.

In its argument Prudential emphasizes the value of the variable annuity as a retirement program and the importance that it be made available to the public by life insurance companies. It points to the strict and comprehensive regulation of insurance companies by the state of New Jersey and the virtues of Prudential's business history and particular form of organization; it then argues that these would fully protect against any abuse in the issuance or management of variable annuity contracts.

Let there be no mistake as to these premises. We here assume, for purposes of this opinion, that the merits of variable annuities are as claimed by Prudential. We shall raise no question as to the adequacy of New Jersey's regulation of insurance companies and activities, nor as to Prudential's own experience or management. We also agree that Prudential, because of the predominant nature of its insurance business, is an insurance company as defined in Section 2(a)(17) of the Act and, as such, excepted from the definition of an investment company under Section 3(c)(3). All of these matters are irrelevant to the issues in this proceeding and our decision.

The true issues are clear and can be simply stated: do the variable annuity contracts constitute or include a relation-

ship subject to the Investment Company Act and, if so, what are the consequences? Prudential's principal and alternative applications would seem to suggest separate discussion of two questions. The first, the coverage of the Act—to what relationships it applies; and the second, the specific provisions—what the Act requires of those relationships to which it applies. For a proper comprehension of the issues, however, these questions should not be so separated. While the letter of the statute operates with respect to each separately, the spirit is seen in their interrelation.

The Investment Company Act is in some respects not an easy statute, but its essence for the purposes involved here is quite clear. The Act designates the relationships to which it applies—most vitally here, that of the contributor to a pool of equity capital managed and invested in securities at his risk. It applies to such a relationship in whatever form or by whomever created. It sets certain requirements—most importantly here, that ultimate control of policy and management be in the hands of those whose funds are at risk.

The whole history and structure of the Act indicate unmistakably that, as Justice Brennan stated in *Securities and Exchange Commission v. Variable Annuity Life Insurance Co. of America* ("Valic"),[10] its provisions "are of particular relevance to situations where the investor is committing his funds to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortune will depend upon the success of the investment," and "where the investor is asked to put his money in a scheme for managing it on an equity basis, it is evident that the Act's controls become vital."[11] That is this case. The contracts here require Prudential to estab-

[10] 359 U. S. 65 (1959).

[11] Id. at pp. 79, 80 (concurring opinion).

lish a fund to be invested in securities for the benefit and at the risk of purchasers of the contracts exclusively.

We hold that the variable annuity contracts create a relationship subject to the Act and, accordingly, deny Prudential's principal application implying they do not. No more rigid or technical application of specific provisions of the Act, our decision follows from its fundamental intent and philosophy to provide certain protections to investors in precisely such "liquid pools of the public savings entrusted to managements to be invested" [12] as that created under the contracts in the present case. Moreover, the basis and logic of the Supreme Court's decision in the *Valic* case indicate this conclusion.

Thus, Prudential is not itself an investment company, but it is the creator of one—and proposes to be its "investment adviser" and "principal underwriter." [13] That an exempt insurance company performs these functions is irrelevant. The Act's exclusion of insurance companies is to be readily explained: otherwise they would fall within the statute by reason of the investment activities which are a necessary ingredient of their insurance business. Where, however, an insurance company (or any other entity) creates a fund exclusively for investment, and sells equity interests in the fortunes of that fund, the exemption does not carry over to the fund. Furthermore, that Prudential may in the same contract also make, in its own name and backed by its own assets, certain insurance or annuity promises is also irrelevant. *Valic* held that such promises do not make the contract as a whole exempt as "insurance" though made by the same entity and backed by the same assets.

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[12] Senate Hearings before the Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong., 3rd Sess. (1940) 33.

[13] Sections 2(a)(19), 2(a)(28).

We next reach Prudential's alternative application which is a request for exemption of this relationship from certain provisions of the Act. The interrelationship between the scope of the Act and the requirements imposed on those it covers leads us generally to deny the requested exemptions—essentially those concerning the control of contract holders (directly or through representatives of their own choosing) over the policy and management of their funds. These provisions are at the core of the entire purpose and scheme of the protections intended by the Act. Their objective is not accomplished by insurance regulation or other outside supervision. The granting of these exemptions would come close to reversing our holding on the principal application.

Our decision here is not in any sense or by any extension a prohibition of the issuance of variable annuities by any organization. We reject Prudential's statement that "the basic issue posed by the alternative application [is]—shall existing life insurance companies be denied the right to offer and sell variable contracts to the public." Whatever may be the problems of a company organized in a special manner, offering a contract in the particular form it elected to write, under a statute newly-amended in terms it assisted in drafting, there can be no assumption that such problems will confront other life insurance companies offering other available forms of contracts in other states under other statutes now or hereafter in effect. Indeed, it seems highly unlikely that any state, including New Jersey, would be reluctant to join with the largest insurance company in its jurisdiction to provide for a legitimate expansion of its business by amending its insurance code.

The essential problem presented is the proper accommodation of two schemes of regulation—insurance and investment company. The two are different in objective, administration, and impact on the affected public; neither

purports to do the job of the other.[4] The variable annuity does not require and cannot justify the subordination of either pattern of regulation to the other. Whether variable annuities require state insurance regulation, and how that is to be applied, are matters for state insurance authorities to determine. This Commission has not the qualification, much less any desire, to become involved in matters of insurance regulation. By the same token, however, state insurance regulation is not a substitute for the application of the 1940 Act. The two schemes need not conflict in their application to the variable annuity if each is applied to its functionally appropriate spheres. We are convinced, on the basis of a study of the problem over a considerable period of time in our general administrative capacity, that accommodation is possible through several possible forms. In this accommodation, all involved must take realistic account of the fundamental legal policies involved and must concern themselves with the substantive relationships created.

The distribution of variable annuity contracts by an insurance company results in the creation of rights, obligations, and benefits, both insurance and investment in nature. These are severable: insurance promises are made solely by the insurance company and supported by its assets (not including the investment fund),[5] investment participations are measured solely by the investment fund (separate from the insurance company's assets). This distinction in interests is recognized by the action of several state

[4] For a description of the differences between the two types of regulation, see the concurring opinion *infra*, supra, at p. 77.

[5] In the instant case it is Prudential that is the obligor of the insurance promises. "Since the obligation to make the contractual payments without regard to the mortality rate actually experienced is an obligation of the Prudential and not of the Investment Fund of the Variable Contract Account, the entire general surplus of the company is committed to the fulfillment of this guarantee." Prudential brief, p. 67.

legislatures requiring that the investment funds under variable annuity contracts be maintained in an account legally separate from the other assets and liabilities of the insurance company, to the exclusive benefit and risk of the variable annuitants, and thus separate from stockholders and other policyholders.[16] The mortality guarantee and other insurance promises, and the management of and interest in the assets behind them, are the business of the insurance company, its stockholders and policyholders as such. The assets of the investment fund, on the other hand, being reserved exclusively to the variable contract holders, are not assets of the company, and the business of the fund is not the business of the stockholders or other policyholders.

Some examples will perhaps highlight the foregoing: An insurance company might form a registered investment company under the Act and sell its shares. This company might offer, as a package, shares in this fund and insurance or annuity policies in itself.[17] Further, an insurance company might offer a variable annuity; the value of each annuity payment to be measured by the then value of shares of an existing (and unrelated) investment company. Alternatively, an existing investment company might offer to holders of its shares a plan for the distribution of shares to the holder on an annuity basis (with or without mortality guarantees).[18]

In the foregoing examples, the insurance company and the investment company would each continue as such and still embody a relationship subject to its applicable law.

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[16] See, e.g., D. C. Code tit. 35-541(a) (1960); Fla. Stat. Ann. § 627.0976 (1961).

[17] *Cf.* Securities Act Release No. 3480 (May 22, 1962) dealing with the sale of mutual fund shares which are collateralized to purchase life insurance.

[18] See Johnson, *The Variable Annuity—Insurance, Investment, or Both?* 48 Geo. L. J. 641 (1960).

Since the substantive relationships survive, the legal results should not change because a given company writes and sells a contract purporting to combine them. If an investment fund is involved or created, the federal law applies. If an insurance company is involved, or promises are made which fall within the definition of insurance, these may be subject to state insurance law as determined by the appropriate state authorities. Thus, they will decide whether to prohibit the sale of variable annuities or to apply additional (as opposed to conflicting) requirements. There need be no conflict of regulation. Each law applies where relevant: the federal law to investment risk; state insurance law to the application of actuarial methods and the performance of promises of fixed amounts (whether in numbers of dollars or of units or of shares).

III.

These broad principles flow from the decision of the Supreme Court in the *Valic* case. In *Valic*, the Supreme Court decided that the variable annuity contracts were securities, not exempt as "insurance," and that the Investment Company Act must be complied with, despite the fact that the company which sold the contracts was formed and regulated as an insurance company. True enough, in that case the company involved was selling principally variable annuity contracts and had relatively little standard insurance business. The substantial difference in the present proceeding is that Prudential has a large and long-established business in standard insurance, which will be greater than its proposed business in variable annuities. Prudential maintains that this distinguishes *Valic*. To us it is quite clear that it does not and cannot. The basis of the Court's decision in *Valic* and the subject of inquiry throughout both that opinion and our subsequent opinion dealing with exemption requests,[19] is solely the variable annuity contract,

[19] *The Variable Annuity Life Insurance Co. of America*, Investment Company Act Release No. 2974 (February 25, 1960).

its provisions, its impact, and the relationship of the holders of such contracts to the fund. There was no reference to any other business of the company, now or hereafter, nor any suggestion that such other business would be in any way relevant. It would be strange indeed that the judgment should lose all effect in the foreseeable event that the company should sell more regular insurance policies than variable annuities. Such a conclusion would make meaningless the opinions' careful focus on the effects of the variable annuity contracts upon their holders.

In the *Valic* case as here, moreover, the contracts included mortality guarantees undertaken by the company itself, backed by its own assets and therefore affecting its stockholders and policyholders. But neither the guarantees, nor the position of those persons were deemed relevant. On the contrary, the basis for the decision was the substantial and severable interest of the variable annuity contract holders in the investment fund only, distinct from stockholders and other policyholders, and distinct also from their own interest in the company as policyholders in regard to the mortality guarantees.

The holding in *Valic* then is that it is the interest and risk of the variable contract holders in the investment fund, not other aspects of the contracts or of the company which sells them, which require subjection to the Act. In the special circumstances of the company in *Valic*, the means chosen for compliance with the mandate was by registration of the company itself. For Prudential this means is neither desirable nor possible. But the relevant relationship is identical and the mandate stands. The difference of the present case from *Valic*, therefore, is not in the substantive applicability of the Act, but only that a different mode of compliance must be sought.

IV.

As to the applicability of the Act, Prudential's basic argument here narrows down to the simple assertion that a status subject to the Act cannot be created by a contract written and sold by an otherwise exempt entity and containing other provisions or relationships not subject to the Act. We have already indicated why such a proposition is patently untenable in substance and effect. We deal now with Prudential's more technical arguments.

Prudential maintains flatly that the Act governs only relationships initially organized in the form of some recognized legal entity. Beside making the statute easy to evade, this proposition flies in the face of its explicit provisions. The Act's definition of "company" includes ". . . a trust, a fund, or any organized group of persons whether incorporated or not. . . ."[20] The contracts create a "trust" in the hands of Prudential for the contract holders. Moreover, they require and result in a "fund." Prudential maintains that this fund "is a lifeless thing incapable of action" and that the term as used in the Act must therefore have a more specific meaning. But it is, of course, a central purpose of the Act to require that an investment fund *not* be a lifeless thing, that it must be *given* the capacity for certain actions. The foregoing conclusions apply quite irrespective of state legislative action segregating the investment fund, though such legislation highlights the points.

The contracts also constitute the holders an "organized group of persons." Prudential states that the holders are "merely scattered individuals and companies who happen to have purchased variable annuity contracts. They have formed no organization among themselves, they take part in no joint activity of any kind, and they have assumed no responsibility toward each other." But this is to argue that

[20] Section 2(a)(8).

a group is not a group because it was some other person who brought it together. It is a principal purpose of the Act to require that a group such as this *have* a certain role and take part in certain responsibilities; it does not leave these matters to contractual whim.[21]

Prudential argues that it, not any "subordinate" "lesser" or "component" entity, is the "issuer." This is a misconception of the obvious and necessary meaning of the word "issuer" in the 1940 Act. It confuses the concept of "issuer" with the functions of the organizer, depositor, promoter, or seller.[22] For purposes of the 1940 Act, the term "issuer" is defined as "every person who issues or proposes to issue any security or has outstanding any security which it has issued."[23] Prudential would in fact be the writer of the *contracts*—the insurance and annuity promises and the obligation to set up the investment fund. But the investment fund, the "company" to which the investment interests relate, is the "issuer" of those interests.

Prudential also argues that the Act applies only to "companies" rather than "activities," and that the operation of the variable annuity contracts and the investment fund thereunder is merely a minor "activity" of Prudential. This is a misconception analagous to that just mentioned. One must first locate the "company"; "company" is and must be defined in terms of unity of interest and participation. It is true that a "company" (in this sense) may engage in investment activities to some extent

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[21] *See The Variable Annuity Life Insurance Co. of America*, Investment Company Act Release No. 2974 (February 25, 1960) p. 25, where we held, with respect to similar variable annuity contracts, that the holders, together with the proceeds of their payments, constituted a "trust," a "fund" and an "organized group of persons" within the meaning of the Act.

[22] Compare Section 2(4), Securities Act of 1933.

[23] Section 2(a)(21).

—or primarily if in an excepted category—without becoming an investment company subject to the Act. It is equally apparent, however, that any company may create an investment fund and sell interests in it. In this event the separate fund is no longer in any real sense an "activity" of the first company, but another and different "company." A contrary conclusion, as urged by Prudential on this basic point, could drastically limit the Act's intended scope.

In this connection, although Section 3(c)(3) of the Act categorically excepts "any bank or insurance company" from status as an investment company, it goes on further to exclude common trust funds and similar collective investment funds created by and maintained by a bank in a fiduciary capacity.[24] Obviously, if as Prudential argues, the exemption of banks and insurance companies had been intended to include an exemption of funds set up by such companies, there would have been no need to provide for the additional specific exemption of funds set up by banks. Congress thus viewed such funds, even though usually maintained as departments of the bank, as separate from the banking business. It rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes rather than as medium for general

[24] The bank funds excepted under Section 3(c)(3) are "... any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian, or any common trust fund or similar fund, established before the effective date of the Revenue Act of 1936 by a corporation which is supervised or examined by State or Federal authority having supervision over banks, if a majority of the units of beneficial interest in such fund, other than units owned by charitable or educational institutions, are held under instruments providing for payment of income to one or more persons and of principal to another or others."

public investment and had only a limited impact in the investment fund picture.[25]

Prudential argues that it is essential to find a "security" which can be identified as "precisely described," and to identify the "owner" of each of these securities. It further points out that the proposed contract contains a number of guarantees and obligations which are not securities of the investment fund, and that during the pay-out period no one annuitant can be designated the "owner" of any specific number of units. Prudential suggests that the contract is "simply not divisible." We disagree; indeed, divi-

[25] See 41 Doc. 476, 76th Cong. (1939) (Report of the Commission on Common Trust Funds) pp. 3-6. Regulation F of the Federal Reserve Board, which governed common trust funds, stated that the use of the common trust fund was for the purpose of the "investment of funds held for true fiduciary purposes; and the operation of such Common Trust Funds as investment trusts for other than strictly fiduciary purposes is hereby prohibited." *Id.* at 27.

Prudential has also pointed to certain decisions by us where we granted exemption from provisions of the Act to companies engaged in insurance and real estate businesses which had outstanding face-amount certificates. (*The Great American Life Underwriters, Inc.*, Investment Company Act Release No. 3070 (July 15, 1960); *American Annuity Savings Association*, 35 S.E.C. 610 (1954); *Collateral Investment Company*, 10 S.E.C. 1083 (1942)). It argues that failure to find that those companies had component face-amount certificate investment companies is a precedent for not holding that the fund has to be an investment company separate from Prudential. However, in those cases the issuance of such certificates had been discontinued and was not to be resumed, and no other investment fund interests had been or were to be issued. We determined that under the circumstances exemption from the Act could be granted, subject to appropriate conditions, during the period the remaining face-amount certificates were being liquidated. Those determinations afford no basis for holding that the proposed issuance of the variable annuity contracts will not give rise to an investment company requiring the protections of the Act.

sion of its elements into investment and insurance components is essential to its performance and to its comprehension. Just as the fund has been identified as the issuer of the units sold through the medium of the contract, so Prudential should be identified as the obligor of certain promises made in the contract. In effect, Prudential's basic undertaking is that the number of annual units allocated to an annuitant (whatever their value) will not be affected by mortality experience; it will make up any inadequacies out of its own assets.[26] The unit is the relevant security and must be located, despite any difficulty in the wording of a particular form of contract. This is further illustrated by the fact that during the pay-in period the contract holder may elect to redeem (in effect, sell) his individual interest in the investment fund at its then value. In this respect, the holder's position is identical to that of a mutual fund shareholder. During the pay-out period, individual interests cannot be so identified or sold. But it is clear that the investment results of the fund affect the amount of each of the payments in this period and therefore the substantive reasons for the application of the Act continue.[27]

Prudential has also argued that, if the Act meant to regulate investment funds managed by insurance com-

[26] In addition, Prudential, not the fund, is also the obligor of other promises in the contract, such as that for issuing a fixed-dollar annuity in exchange for the variable payments.

[27] "But the individual payment is still a payment measured logically in the same way as one's interest in an investment trust is measured. And in a very real sense the investor is more vitally interested in the investment experience of the company at this period than he ever was in the pay-in period, and in a way more vitally than any holder of an open-end investment company certificate or share in a publicly traded closed-end company ever is, for he has become completely 'locked in.'" *Valic*, *supra*, at p. 80 (concurring opinion).

panies, fire insurance companies would have been excluded from the insurance exemption because it was known that these companies derived their income primarily from investments in equity securities rather than from fire underwriting operations. It is a sufficient answer that the Act exempts the latter, but not the former. That is the selection Congress has made. In any event, fire insurance companies are formed primarily to insure and underwrite risks from fire and similar events and their invested funds are available for such purposes. The fund with which we are concerned here is not an insurance company; it is to engage exclusively in investment and is to be advertised as such.

Finally, Prudential argues that the insurance exemption contains two features which, as revealed in the legislative history, were fundamental to the Congressional judgment as to the type of companies which should be exempted—a "primary and predominant business activity test" and a prior regulation test—and that it satisfies both. We do not disagree with the first test as such; but, upon identifying the fund, we have not found it in the insurance business. As to the second, the Supreme Court in *Valic* rejected the argument that Congress intended to exempt "regulated" companies from the reach of the Act; the company in that case was subject to the jurisdiction of local insurance authorities.[28] As we stated earlier,[29] the exemption of insurance companies is to be explained in that otherwise such companies would be covered because of their investment activities, a necessary part of their insurance business.

Accordingly, we find that the sale by Prudential of the variable annuity contracts will result in a fund—the Investment Fund account—which will invest, reinvest or trade in

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[28] *Valic*, *supra*, at pp. 67, 75 (1959).

[29] See text *supra*, p. 13.

securities and be therefore subject to the Act.[30] Further, the contracts which provide for periodic payments, redemption and undivided interests in a unit or fund of securities, come within the definition of periodic payment plan certificates contained in Section 2(a)(26) of the Act.[31] The

[30] See Section 3(a). The National Association of Securities Dealers, Inc. ("NASD") has suggested that the Other Assets account is also a part of the investment company. As we have noted, the Other Assets account—which may invest in securities—is an administration account which will hold the payments for sales and administration expenses and insurance surplus. Under the circumstances, the Other Assets account need not register under the Act. In one sense it is clear that the contract holders have an interest in the Other Assets account; it is funds from this account which must be transferred to the Investment Fund to assure that the assets of the Fund shall be equal to Prudential's total reserve—annuity—liabilities under the variable contracts. Presumably state insurance authorities will continuously assure that this equality is maintained. Aside from the reserve liability, any excess in this account over liabilities belongs to the contract holders only in their capacity as policy holders of a mutual company and not as investors in an investment company.

Under Section 5(a)(1) of the Act, the fund is an open-end company since it issues redeemable securities. During the pay-out period, the purchaser's status is similar to that of an investor in a closed-end company, except that life contingencies affect the measure and duration of his interest. While the pattern of regulation designed for open-end companies appears most appropriate, as we did in the *Valic* case we shall examine the requested exemptions in light of the Act as a whole.

[31] Section 2(a)(26) defines "periodic payment plan certificate" to include "any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments." A number of regulatory consequences attach upon the issuance of periodic payment plan certificates. See Section 27.

In the report of this Commission relating to "Companies Spon-

issuer of these certificates might be regarded as a separate investment company, a unit investment trust as defined in Section 4(2);[32] but as a practical matter, this would be of no consequence so long as the fund were to register.

In its alternative application Prudential purports to accept the premise that the investment fund is subject to the Act, but requests an order exempting the fund from the provisions of Section 7 which in general prohibits transactions by an investment company unless registered with us. This order would be conditioned on Prudential's consent to comply with all but a limited number of specified provisions of the Act and to a partial compliance with some of the latter pursuant to the provisions of Section 6(c).

We consider the form of the application mistaken. The entire scheme of the Act is constructed around registered

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soring Installment Investment Plans." ("Installment Plan Report"), periodic payment plans were described as follows:

> "a contrivance for selling the familiar varieties of investment trust or investment company securities on a periodic or installment payment basis. Certificates representing participation in the installment investment plan were the 'securities' which were sold directly to the public. The certificate or 'security' sold to the public evidenced the beneficial ownership of the holder of the certificate in an account to which were credited shares or interests in other securities 'underlying' the installment investment plan. Under most of the plans these underlying securities were shares of another designated investment trust or investment company . . . In other cases the underlying securities purchased under the plan were common stocks in which beneficial participations were credited to the certificate holder."

H. Doc. No. 482, 76th Cong. (1939) pp. 3-4.

[32] Section 4(2) defines such a trust as an investment company which issues redeemable securities representing undivided interests in a unit of specified securities and which is organized under a trust indenture, contract of custodianship or agency, or similar instrument, and does not have a board of directors.

investment companies to which the specific provisions are made applicable and from which exemptions may be granted, if appropriate. There is no justification here for reversing this scheme by a complete exemption accompanied by voluntary consent to certain of the Act's provisions. We, accordingly, treat the application as requesting exemption under Section 6(c) in whole or in part from the specified provisions and shall refer to the issues presented as involving requests for exemptions. . .

Section 6(c) provides that we may grant exemptions, conditionally or unconditionally, from provisions of the Act "if and to the extent that such exemption is necessary, or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. As we have noted on prior occasions, this section was designed for exceptional situations where compliance is not necessary to accomplish the Act's objectives and policies; the authority conferred must be exercised with circumspection.[33] Most importantly here, we must tread lightly since basic to Prudential's present plan of operation is total non-compliance with crucial sections of the Act, or so-called compliance, which is not such in fact, with other important sections. It is to these sections that we shall first turn our attention.

Provisions Relating to Investor Control

Under New Jersey law, the holders of the variable annuity contracts would with 17,000,000 policyholders of Prudential, be entitled to vote only on three matters: (1) approval of any proposed merger of Prudential with

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[33] See *The Variable Annuity Life Insurance Company*, Investment Company Act Release No. 2974, p. 7 (1960); *The Great American Life Underwriters, Inc.*, Investment Company Act Release No. 3070 (July 15, 1960); *American Participations, Inc.*, 10 S.E.C. 430, 437, n. 8 (1941).

another mutual insurance company; (2) the amendment of Prudential's Charter; and (3) the election of 16 directors. In addition to the 16 elected directors, the board of Prudential consists of six members appointed by the Chief Justice of the Supreme Court of New Jersey and one member, the president of the company, elected by the other directors. The contract holders may not nominate directors, since the elected directors nominate their successors and the appointed directors have the power to create a contest, in which case a nominating committee appointed by the New Jersey Commission of Banking and Insurance submits a slate of nominees.[34] Prudential will be the permanent investment adviser and principal underwriter to the fund. Prudential would have us find this establishment consistent with the Act.

Prudential's proposals clearly contemplate, in effect, a total exemption from all of the sections of the Act which together express and effectuate the policy that those at risk in investment funds should have ultimate voice in their management and policy. As we have indicated throughout this opinion, that policy and those sections are in large part the very essence of the Act.[35] To grant exemptions

[34] There has never been a contest with respect to Prudential's directors. There are no quorum requirements or solicitation of proxies, and during the years 1958 and 1959, 0.0035530% and 0.004%, respectively, of Prudential's policyholders voted for the election of directors.

[35] See Presidential message vetoing H.R. 7842, 87th Cong., 1st Sess. (1961), which would have permitted District of Columbia life insurance companies to establish certain voting and management procedures with respect to variable annuity contracts. The President pointed out that the purchaser of a variable annuity depends largely upon the efficiency and skill of the management in selecting and managing the underlying portfolio securities for the return upon his investment. He stated that the bill failed to give adequate recognition to the basic principle, recognized in the Investment Company Act, that the investor have a voice in the control of his company. H.R. Doc. No. 243 (September 26, 1961).

here would be in effect the equivalent of a total exemption and contradictory to our principal holding.

Specifically the Act requires that those having funds at risk in the equity securities of an investment fund elect its directors.[36] The directors or the holders must recurrently review the principal underwriting and investment advisory arrangements and have the power to change or terminate them.[37] Holders must pass on changes in investment policy[38] and ratify the selection by the directors of the independent auditors of the fund.[39] The percentage of directors of the fund who may be affiliated with the investment adviser is subject to strict limits.[40] The effect of these sections is not only to place the power of control in the holders, but to prevent its usurpation by any others, management or outside party, through long-term contract or otherwise. The purpose is not only to secure honesty

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[36] Sections 16 and 18.

[37] Section 15. It has been held that Section 15 lays down a requirement of annual approval not merely formal, but substantial, the minimum content of which is a matter of federal law. *Brown v. Bullock*, 294 F. 2d 415, 421 (C.A. 2 1961).

[38] Section 13.

[39] Section 32(a).

[40] Section 10. "One of the conditions as to which Congress expresed its concern was the management of investment companies in the interest of investment advisers, underwriters and other affiliated persons rather than in the interest of its security holders. To guard against recurrance of this evil, a keystone provision of the statute requires that a board of directors be so constituted as to provide an independent check upon 'management'. Section 10 of the Act specifies that, except for certain "no load" companies, at least 40 per cent of the directors of a registered investment company must be persons who are neither officers nor employees of the company and are unaffiliated with its investment adviser." *Fundamental Investors, Inc.*, Investment Company Act Release No. 3596, p. 5 (December 27, 1962).

and objective "wisdom" in management, but to make it separately responsive to the wishes and judgment of those who depend upon its results."[1]

Prudential states "Control of, and responsibility for, the affairs of the Investment Fund and the variable contracts proposed to be issued will be vested in the Company's Board of Directors. The Investment Fund will not have and could not have a management structure apart from the company's. Accordingly, it appears that the directors of the company may be regarded as the directors of the Investment Fund . . ." It states that the contract holders will, as policyholders, have one vote each for directors of Prudential. It proposes that its directors may for the pur-

[1] Other sections reinforce the mandate of the Act that security holder representation and participation are to be provided and safeguarded. Shareholder approval is required when the issuance of additional shares might dilute the value of outstanding shares. Section 23(b)(2). Compliance with our proxy rules is required and voting trusts are prohibited with respect to an investment company's securities. Sections 20(a) (b). Additional provisions of the Act, for example Sections 12(d)(1) and 20(e), and (d), which prohibit cross-and circular ownership, are directed to the elimination of other devices through which ". . . public investors are effectively denied, in many instances, any real participation in the management of their companies." Sen. Rep. No. 1775, 76th Cong., 3rd Sess. p. 7 (1940). The "Findings and Declaration of Policy" contained in Section 1(b) of the Act state that the national public interest and the interest of investors are adversely affected "(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders"; and "(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed or when investment companies are managed by irresponsible persons."

poses of Section 10 be considered directors of the fund. It says that the fund will not have an independent investment adviser, but its Board will determine the investment policy of the fund.

Prudential's proposals on these points do not approach substantial compliance with either the letter or the spirit of the Act. In effect, Prudential proposes to keep to itself the power to designate, in perpetuity, the management, policy, and operations of the fund. The variable annuity contract holders will vote for the managers of their assets only in conjunction with approximately 17 million policyholders who do not share their interests. Furthermore, there is no provision for the minimum number of unaffiliated directors required by Section 10. These arrangements are not consistent with the purposes of the Act to endow fund holders with the exclusive right to elect their representatives through whom their rights and interests can be pursued.[42]

Moreover the protections of Section 15, designed to make effective shareholder control over the management of their investment funds and the public distribution of shares, are particularly needed under the variable annuity contract.[43] Here the investor's fortunes are dependent upon the results of investment management not only while he may redeem his interest but also during the pay-out when he is no longer free to terminate his investment. Yet

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[42] *See Insured Accounts Fund*, 38 S.E.C. 123, 127 (1957), where in denying a request for exemption from the provisions of Sections 16 and 18, we noted a potential conflict of interest existed between the management and sponsor of the fund. See also *Investors Diversified Services, Inc.*, Investment Company Act Release No. 3474 (April 27, 1962).

[43] See Hearings before Subcommittee of Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3rd Sess. (1940), p. 253, where a Commission spokesman stated: "... if the stockholders or the board of directors are displeased with the management, they ought to have a right to terminate the [management] contract."

Prudential would be the permanent investment adviser and principal underwriter of the fund.

It is no answer to these problems that the contract holders are free to dispose of their interests and seek a similar investment under a different management. So may any shareholder of any investment company. Aside from the burden of sales loads, and other costs, involved in transferring investments, it is clear that the Act does not regard alienability as a proper substitute for the investors right to a management of his choice.[44] Moreover, to the variable annuity holder, this recourse is substantially limited since he is locked into his investment during the pay-out period by the very nature of the contract.

Finally, Prudential has argued that, under its particular form of organization and under New Jersey law, it cannot comply with these basic sections of the Act. It appears to us too early to be certain that ways might not be found to accomplish something approaching recognition of the Act's policies. This Commission is not doctrinaire in providing some flexibility through exemptions. Further, as earlier noted, accommodation by the states may in all probability be anticipated to facilitate legitimate expansion of the business of insurance companies. Under any circumstances difficulties under existing New Jersey law do not justify such broad exemptions as are requested here, particularly since they must be equally available to insurance companies in all 50 states.[45] Prudential doubts the necessity, or practical value, of these provisions of the statute. We do not accept

[44] *Saminsky* v. *Abbot*, (Del. Ch. September 18, 1961), No. 1324.

[45] "But in the final analysis, it is not decisive of the issues here that a holding that these contracts are subject to the Federal Acts might require some modification in the business of issuing them. Since these contracts are in fact covered by the Acts, there can be no reason why their issuers should be able to carry on the investment business in a way which Congress has forbidden." *Valic*, *supra*, at pp. 92, 93 (concurring opinion).

the implications of these suggestions, but in any event it is not for Prudential or this Commission to neglect policies so central to the Act.

Accordingly, we deny the specifically requested exemptions from Sections 16 and 32. We further hold that the fund's proposed form of organization conflicts with the requirements of numerous sections of the Act dealing with investor control, such as Sections 10, 13 and 15. Adjustments would have to be made so as to render effective the rights prescribed by those sections—exemptions here would also be inappropriate.

We now turn briefly to the other exemption requests made by Prudential. These are, of course, almost meaningless in the context of the structure presented here. We shall, however, express our views or exercise our powers to indicate what further compliances will be required.

Provisions Relating to Redemption

Prudential seeks exemption from Section 27(c)(1), which requires periodic payment plan certificates to be redeemable securities[46] and from Section 22(e), which prohibits the postponement of payment upon redemption of such securities for more than 7 days after tender of the security for redemption. The proposed contracts limit redemption in a number of ways which run counter to these prohibitions, including non-redeemability during the pay-out period, except to provide annuity payments, and a 36-month liquidation process during the pay-in period.[47]

[46] Section 2(a)(31) defines "redeemable security" to include any security under the terms of which the holder is entitled to receive, upon presentation to the issuer or its designee, approximately his proportionate share of the issuer's net assets or the cash equivalent.

[47] The three-year payment period is required by New Jersey law: N. J. STAT. ANN. § 17:35A-5(d) (1959). If the value of the units is less than $1,000, payment will be made in no less than 30, nor more than 60, days after presentation of the contract for redemption.

With respect to the non-redeemability of the contracts during the pay-out period, we recognized that the very nature of the variable annuity arrangement entails mortality assumptions and undertakings on the part of Prudential which would be adversely affected by the unilateral withdrawal of unliquidated units by an annuitant during the annuity period. Non-redeemability comes into play only after a specified interval during which redemption is permitted and serves to make the life-annuity feature feasible. Under these circumstances, we believe it appropriate to grant the exemption from Section 27(c)(1) for the pay-out period.[48]

The proposed postponement of redemption during the pay-in period stands on a different footing. During that period only the accumulation of units by the investor is involved and the variable annuity program is not impaired or altered by redemption. Our holding in the *Valic* case that the provisions of Section 22(e) should be applied to variable annuity contracts is dispositive of the issue and we deny the requested exemption.[49]

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[48] The Division has argued that the use by Prudential of a 2½% investment increment assumption in computing the number of units to be paid to an annuitant during the pay-out period will result in inequitable and discriminatory treatment among annuitants and, accordingly, urges that we adopt a "highly restrictive approach" to the exemption requests. The Division's argument essentially is based on the fact that Prudential's investment increment assumption, which includes no assumed capital gains or losses, allegedly results in a continuing deferral of a major portion of capital gains realized by the fund with the effect that an annuitant who dies early does not receive his fair share of the appreciation from his investment. We do not accept the Division's position here. We do not consider the formula proposed to be inherently unfair or inequitable. To the extent that actuarial factors are involved in the application of the investment assumption they will be subject to the regulatory scrutiny of the state insurance commission. Moreover, we shall have jurisdiction to consider the adequacy and accuracy of the disclosures with respect to its practical impact.

[49] *The Variable Annuity Life Insurance Co. of America*, Investment Company Act Release No. 2974, pp. 20-21 (February 25, 1960).

Provisions as to Offering Price

Exemption is sought from Section 22(d), which prohibits the sale of a redeemable security at a price other than the current public offering price described in the prospectus, so as to permit the sale of variable units at a price other than their current value to persons who have failed to make their monthly purchase payments and desire to cure the default. A monthly purchase payment not made within thirty days after its due date is considered in default. The contract holder may resume payments within one year after the date of default by paying a lump sum equal to the aggregate of the defaulted payments plus that for the current month. The number of units credited will be the lesser of (a) the number which could be purchased at the current unit value or (b) the number which would have been credited if each payment had been paid when due.

We agree that it is appropriate to require that the contract holder pay the current value at the time of resumption if the value of the units has risen since the default. To credit him with units at the lower value which obtained at the time his payments were originally due would dilute the interests of the other investors. This requirement amounts to no more than charging the current offering price of the units and does not involve any conflict with Section 22(d).

However, where the value of the units has declined, no dilution results from crediting the purchaser with units at the lower value prevailing at the time of his late payment; to charge him with the higher value which previously existed would represent a penalty. We think such a penalty, even aside from the fact that in particular situations its amount could be very large,[59] would be inequitable. It is

[59] The Division introduced an exhibit showing that, in a declining market, the proposed provision would have resulted in a holder who resumed payments after default in eight monthly payments losing 28% of the total of such payments. Viewed as a sales load the penalty in question might exceed the maximum of 9% pre-

not justified by Prudential's asserted desire to encourage regularity of payments and to prevent speculation in fund units and has no reasonable relationship to services rendered. Under these circumstances, we conclude that the requested exemption should not be granted.

Other Requested Exemptions

1. *Section 30(d) and Rule 30d-1*

Prudential requests exemption from Section 30(d) and Rule 30d-1. Those provisions would require the fund to furnish to the variable contract holders, at least semi-annually, a report which, among other things, contains statements in the nature of a balance sheet and income statement and shows changes in net assets, the unit values and dividends for the current and past three years and whether the dividends were from net income or capital gains, a list of securities owned and their value, and the remuneration paid to directors, officers, and certain other persons.

Prudential proposes to send annually a report conforming to the above requirements. In lieu of a semi-annual report, however, Prudential proposes, as required under New Jersey law, to transmit within two months after the anniversary date of each contract a report containing, for contracts in the pay-in period, the number of units accumulated under the contract, including any resulting from the apportionment of divisible surplus, and the unit value as of the anniversary date. For contracts in the pay-out state, the report will show the number of units in each annuity payment and the current unit value.

Prudential argues that the semi-annual report would impose unnecessary expense upon the contract holders be-

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scribed in Section 27(a)(1), or be "unconscionable or grossly excessive" as proscribed by Section 22(b). Construed as an administrative charge, it could exceed a "reasonable amount," the standard of Section 27(a)(5).

cause the other two reports supply the information necessary for an intelligent exercise of a security holder's right to sell or redeem his security. It further contends that frequent reports would tend to create the erroneous impression that the variable annuity contract is an appropriate medium for short-term speculation.

Section 30(d) was designed with specific regard to curing the evils that resulted from the failure to give investors full information.[51] The variable annuity contract holder is, as has been seen, in a similar position to that of an investor in a conventional investment company and has the same needs for the information prescribed by the Act and the Rule. The legislative history indicates that there was a balancing of these needs against the expense involved in a semi-annual reporting and Congress resolved the question in favor of requiring such reports.[52] Accordingly, we deny the requested exemption.

2. *Sections 27(a)(3), 17(f) and 27(c)(2)*

Exemption is requested from the provisions of Section 27(a)(3) to permit deduction of sales loads which differ proportionately in various periods. These differences, according to Prudential, result from reductions in commissions to the selling agents after the first year. The percentage deducted from each purchase payment after the first year for sales load, administrative expenses, pre-

[51] Section 1(b)(1) recites that investors are adversely affected when they "purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit, information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management."

[52] Senate Hearings before Subcommittee of Committee on Banking and Currency on S. 3580, 76th Cong., 3rd Sess. (1940), pp. 302-303.

minum taxes and additions to surplus is constant, with any decrease in the sales load being offset by a corresponding increase in additions to surplus. We agree that under the circumstances the requested exemption should be granted. However, we reserve jurisdiction with respect to the reasonableness of charges for administrative expenses.

Exemption is also requested from Section 17(f) and Rule 17f-2 which require that securities of a registered investment company be deposited in a bank for safekeeping and access to them be limited to no more than 3 authorized persons. Prudential proposes to keep the funds securities in its vaults and to authorize access by a maximum of twenty persons. Prudential's safekeeping facilities, the procedures for access, and the supervision of these matters which is provided appear to afford adequate safeguards against unauthorized removal of securities and make it appropriate to grant this exemption.

A further exemption is sought to permit Prudential to hold the proceeds from the sale of the variable annuity contracts instead of depositing them with a bank or custodian as required by Section 27(c)(2). In the light of Prudential's position in relation to the contracts and the existing supervision and inspection of its funds, we grant this exemption.

An appropriate order will issue.

Commissioners Woodside, Cohen and Whitney join in this decision; Commissioner Frear was absent and did not participate.

/s/ Orval L. DuBois
Orval L. DuBois
Secretary

[SEAL]

Order Declaring Status and Granting and Denying Exemptions

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

January 22, 1963

In the Matter of

THE PRUDENTIAL INSURANCE COMPANY OF AMERICA

File No. 812-1386

Investment Company Act of 1940

The Prudential Insurance Company of America ("Prudential") having filed an application pursuant to the Investment Company Act of 1940 ("Act") requesting an order (i) declaring that the proposed offer and sale of Prudential of certain variable annuity contracts will not result in any investment company subject to the Act because Prudential is the issuer of such contracts and is excepted from the definition of an investment company, or, alternatively, (ii) exempting a proposed unincorporated fund which will be created pursuant to such contracts from compliance with various provisions of the Act;

Hearings having been held on said application after appropriate notice, proposed findings and briefs having been filed by the parties and participants in the proceedings, and the Commission having heard oral argument, and having this day issued its Findings and Opinon, on the basis of such Findings and Opinion:

IT IS ORDERED that the request of Prudential that it be declared the issuer of the proposed variable annuity contracts and that no investment company subject to the Act is the issuer, be, and it hereby is, denied.

IT IS FURTHER ORDERED that the application be, and hereby is, denied to the extent that exemption is sought on

behalf of the unincorporated investment fund created out of the proceeds of the sale of the proposed variable annuity contracts from

a) The provisions of Sections 7(a) and 7(b) prohibiting certain transactions by unregistered investment companies;

b) The provisions of Sections 16(a) and 32(b), and relating to voting rights in the election of directors and with respect to contracts with investment advisers and underwriters and the employment of independent accountants.

c) The provisions of Sections 27(c)(1) and 27(e) in order to permit deferral of payments upon redemption by contract holders for periods in excess of 7 days from presentation of the contracts for redemption during the so-called pay-in period of the contracts.

d) The provisions of Section 22(d) in order to permit charging a variable annuity contract holder who has defaulted in his monthly purchase payments under the contract with more than the current value of the units in the investment fund when he resumes payment.

e) The provisions of Section 30(d) and Rule 30d-1, requiring the submission of semi-annual reports.

IT IS FURTHER ORDERED pursuant to Section 6(c) of the Act that exemption be, and it hereby is, granted from

a) Sections 27(c)(1) and 22(e) so as to permit the absence of a right of redemption during the so-called pay-out period of the proposed variable annuity contracts and the payment to holders of such contracts of the current value of their units during that period on the periodic basis proposed in the contract.

b) Section 27(a)(3) so as to permit the amounts of sales load to be deducted from purchase payments made

in certain periods to differ proportionately from those deducted in others, subject, however, to the condition that management fees and administrative expenses to be charged in connection with the variable annuity contracts shall not exceed such reasonable amounts as this Commission shall prescribe, jurisdiction being reserved for such purpose.

c) Section 27(a)(2) so as to permit Prudential to hold the proceeds from the sale of the variable annuity contracts instead of depositing them with a bank or custodian;

d) Section 17(f) and Rule 17f-2 thereunder so as to permit the investment fund to keep its securities in Prudential's vaults and authorize access by a maximum of 20 persons.

By the Commission.

/s/ ORVAL L. DUBOIS
Orval L. DuBois
Secretary

[SEAL]